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IRS to increase scrutiny of 'micro captive' insurance companies

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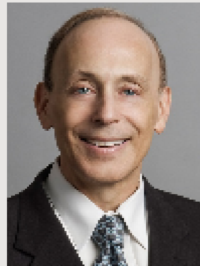

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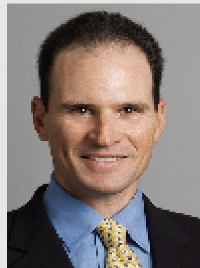

Premiums are taxable income to most insurance companies. However, in 1986 Congress added Section 831(b) to the Internal Revenue Code, a tax incentive for small property and casualty insurance companies. It allows a P&C company to elect to not pay tax on its premium income if the premiums do not exceed $1.2 million. (On Jan. 1, this limit increases to $2.2 million.)

Typically Mom and Dad, who own a closely held business, set up a P&C company in one of the 36 states (which do not include California) with favorable legislation. The operating business then pays - and deducts - a premium to the insurance company Mom and Dad own. An independent actuarial firm determines the premiums and manages the P&C company so that it meets the requirements of the department of insurance of the state in which the P&C company is incorporated.

This structure got its start in the 1950s when Youngstown Sheet & Tube faced a difficult P&C market. Fred Reiss, its insurance agent, solved the problem by having his client set up a wholly owned insurance company. The subsidiary provided the first layer of coverage and went into the reinsurance market for the excess. The term "captive" came from the steel industry, in which a mine producing steel for one company was referred to as a "captive" mine. In the insurance industry, P&C companies set up by closely held businesses are often referred to as "micro captives" to distinguish them from insurance companies owned by such giants as Microsoft and AT&T.

A small P&C company must meet many requirements. Here are two. First, it must have risk distribution, often referred to as the "law of large numbers." In Rev. Rul. 2002-90 the IRS provided that there must be at least 12 operating entities paying premiums to the small P&C company. Second, the premiums must be "ordinary and necessary" expenses for the operating business. For example, if the operating business has gross revenues of $10 million and net revenues (before the premium) of $1 million, an $800,000 insurance premium is too large.

The IRS has been increasingly unhappy with micro captives. In February 2015, the IRS added them to its "Dirty Dozen" for the 2015 filing season. IR-2015-19. The IRS characterized them, in part, as follows: "Another abuse involving a legitimate tax structure involves certain small or `micro' captive insurance companies. ... unscrupulous promoters persuade closely held entities to participate in this scheme by [helping them] create captive insurance companies ..., drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and `selling' ... often times poorly drafted `insurance' binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant `premiums,' while maintaining their economical commercial coverage with traditional insurers. ... Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade."

This IRS's unhappiness is on full display in a pending U.S. Tax Court case *Avrahami v. Commissioner*, in which two Arizona jewelers created a captive insurance company to protect their business and real estate. The IRS attack seems strong because, among many other bad facts: (i) the only coverage offered in the initial years under audit was for damage caused by an act of terrorism; (ii) the premiums greatly exceeded those for similar insurance from commercial carriers; (iii) the taxpayers never conducted a study of how much additional insurance was needed; (iv) the premiums were not determined by an actuary; (v) the captive loaned money back to entities controlled by the Avrahamis within three months of receiving the premiums; and (vi) the lawyer who drafted the policies and ran the pooling arrangement entered into a "tax planning" engagement agreement with the taxpayers.

Last week, the IRS increased the pressure in Notice 2016-66. It has labeled virtually all micro captives as "Transactions of Interest." As a result, "participants" and all "promoters," going back to Nov. 2, 2006, must file, within 90 days, an IRS Form 8886, the "Reportable Transaction Disclosure Statement." Failure to file the form may result in an IRC Section 6707A penalty, which is 75 percent of the reduction in the tax reported on the return. The annual maximum penalty for failure to disclose cannot exceed $10,000 for an individual and $50,000 in other cases.

Critics of micro captives have called Notice 2016-66 a "nuclear weapon" and claimed that this will result in the termination of most micro captives and will stop the formation of new ones. If that turns out to be true, that will be unfortunate. Most micro captives were formed by thoughtful captive managers who vetted the taxpayers to ensure the captives address P&C, not income tax, issues. Premiums were determined actuarially and are "ordinary and necessary" for the operating business. These quality captive managers typically have 100 to 400 captives participating in their risk pools. We can expect them to vigorously resist an IRS attack on one of their clients. Assume the cost of Tax Court litigation is $1 million. Asking each pool member to contribute $2,500 to $10,000, depending upon the pool size, to a litigation fund, is a reasonable cost to protect each member's hundreds of thousands of dollars of deductible premiums.

This battle that will play out over the better part of a decade. Expect the IRS to steer clear of thoughtfully created and operated captives managed by quality managers.